Stefan Ingves: A cure for crises – confidence, confidence and trust

Speech by Mr Stefan Ingves, Governor of the Sveriges Riksbank, at the Eurofi Forum, Gothenburg, 29 September 2009.

* * *

It is an honour for me to hold this keynote address at the EuroFi-conference here in Gothenburg. We have recently witnessed a financial crisis of historic proportions. We may have seen the worst, but the crisis is not over. The development of the last year gives me an excuse to address a topic that has followed me for much of my working life: namely financial crises and trying to sort them out. I could go on and talk about financial crises for hours, but I promise you that I will stay – at least roughly – within my time limit.

I have been working with the resolution of financial crises for almost two decades. I started out, here in Sweden, with the banking crisis of the early 1990s. Later, I toured the world as an IMF employee, assisting in crisis resolution in many different countries, and I came to know many difficult situations from within. In my present role, the last year has, to a large extent, been about dealing with the repercussions of the latest financial crisis. One difference this time is the magnitude and the global reach of the crisis – it is not really just any other domestic crisis. However, I do believe that financial crises are related creatures – or monsters if you prefer. On a fundamental level, all crises share causes and cures but they also have many differences. The cure is made up of two ingredients: 1) regain confidence to resolve a crisis; and 2) preserve confidence to prevent a crisis from repeating itself. Given the international dimension of this crisis and the proliferation of cross-border banking, the cure for this crisis also involves a third component – trust between authorities to enhance cross-border crisis management. So, the outline of my speech can simply be stated as: confidence, confidence and trust!

Most financial crises will involve banks because banks are special. Banks are both central to all economic activity, due to their role in the payment system, and inherently unstable, due to the maturity mismatch from borrowing short and lending long. To avoid a run, a bank must maintain the confidence of depositors and market participants. If a bank loses the confidence of its customers, it faces problems. If confidence for the entire banking sector disappears, a financial crisis is a fact.

The underlying idea of my cure is quite simple. Confidence is essential to operate a bank. Consequently, confidence is essential to prevent and resolve financial crises. More precisely, to resolve a crisis, the cure should restore the public's and the market's confidence in the banks. This should be done by acknowledging the losses and dealing with the bad assets. To prevent this crisis from repeating itself, measures should be taken to ensure that confidence does not dissipate so rapidly again. To this end, liquidity and capital regulation need to be reformed. The final ingredient in the cure is trust. This ingredient stresses the importance of trust between national authorities to the efficient management of cross-border crises.

Regaining confidence in the short run: go get the lemons!

Banks create confidence by telling good and credible stories about the future, stories about why you will get your money back. Money may make the world go around, but it is good confidence-building storytelling that spins the money around. When these stories fail to create confidence, the markets will dry up. This is basically an example of the well-known lemon problem.

The current problems first surfaced in the US subprime market. The repackaging and sale of assets backed by subprime loans meant that the crisis, at its outset, had already started to grab hold of banks internationally. Bankers exposed to subprime assets began to find it increasingly difficult to tell convincing stories. Banks and market agents became less willing to trade and to lend to each other. In March 2007, Bear Stearns received emergency lending, followed by a forced sale. Rating downgrades and more bad news kept arriving and the crisis started to spread geographically and to affect more markets. Banks experienced serious funding problems. The ECB and the Fed responded by injecting liquidity on August 9, 2007. On September 13, Northern Rock received emergency liquidity support from the Bank of England. Concerns for bank-to-bank contagion due to interconnectedness resulted in a loss of confidence for the entire banking system. In 2008, bad events continued to unfold. In the summer of 2008, the US government was forced to rescue Fannie Mae and Freddie Mac. The relatively slow build-up of the crisis abruptly came to an end when Lehman collapsed on September 15. Confidence simply disappeared and liquidity evaporated. Several banks got into severe difficulties: Merrill Lynch, Hypo Real Estate, Bradford & Bingley, Fortis, Dexia and the Icelandic banks: Landsbanki, Glitnir and Kaupthing, to mention a few. A melt-down of the financial system was prevented by a massive intervention by central banks and governments worldwide.

A loss of confidence is the driver of a liquidity crunch, but the lemon problem, as first noted by George Akerlof in 1970, explains the mechanics of a market breakdown. A lemon is an asset of bad quality, originally referring to poor quality cars. In short, the lemon problem arises when sellers know whether or not their asset is a lemon, but potential buyers cannot tell the difference. The risk of purchasing a lemon will lower the price buyers are willing to pay for any asset and, because market prices are depressed, owners of non-lemon assets will be unwilling to put them up for sale.

In normal times, banks can obtain short-term finance by borrowing on the interbank market and by selling assets. When it became apparent that some assets had turned sour – that they were lemons – confidence in the strength of individual banks' balance sheets was eroded. Confidence in the banking sector as a whole was eroded, given the uncertainty over the extent of the problem – uncertainty over where the bad assets were located and the fear of possible bank-to-bank contagion. Such uncertainty over the extent and location of lemons, coupled with a fear of contagion, are normal features of any crisis. However, the opacity of some of the new financial products and the increased interconnectedness of the financial system inflated the degree of uncertainty and the fear of contagion, compared to past crises. The lack of confidence between the banks resulted in the breakdown of interbank markets. At the same time, previously liquid asset markets completely dried up, due to the lemon problem. As a consequence, banks found it costly – or even impossible – to obtain liquidity by selling assets.

Basically, when there are lemons out there, bankers cannot tell convincing confidence-creating stories about the future. A precondition for the return to normal conditions, that is, to a situation where banks do not depend on central banks for liquidity, is that confidence is restored. Central banks have been injecting liquidity for two years now, but still the underlying problem – the lack of confidence – has not been fully solved. Normality will not return until the impaired assets are dealt with. Consequently, we convincingly need to go and get the lemons!

To do that is both messy and costly. A difference to previous crises is the new financial products that have turned sour. It will be difficult to deal with these opaque and complicated new breeds of lemon. However, this does not make it less important to get the lemons – rather the contrary. There are also no shortcuts in dealing with bad assets. The losses must be recognised. A loss is a loss. The costs involved may make it tempting to sugar-coat the lemons by letting the bad assets be valued above market value, but this will only postpone the recovery.

One possible approach to dealing with bad assets is through various forms of asset relief measures. However, if asset relief is offered, then the pricing must be set at conservative market values. A transfer value set above the market value is basically a transfer of money from taxpayers to bank-owners. This could also be costly over time, in terms of increased moral hazard. In addition, pricing above market prices may destroy the asset market for years to come and thus add to the costs of the crisis. To restart a market, it is crucial that investors become confident that the bottom has been reached. This confidence can only be achieved by the realistic and transparent valuation of assets. Once at the bottom, people will start to listen to good stories about the future again. Risk appetite will return and market activity will pick up. In my view, a key part of the successful resolution of the Swedish banking crisis in the 1990s was that the impaired assets were assigned realistic and conservative values. Removing the suspicion that bad surprises may linger around the corner is essential to restarting a market. It is a matter of confidence.

Similarly, the lack of confidence in the banks' balance sheets cannot be improved by creating opaque accounting rules. The book value of a bank will increase if we assign book values above market value, but will it restore confidence? Again, to regain confidence, the balance sheets of banks should reflect realistic values.

Accounting rules should force banks to disclose what their assets are worth and not allow problems to be hidden. Lack of confidence arises over concerns about a bank's actual financial situation. If market participants have to recalculate reported valuations, then the return of confidence will be more difficult to achieve. It is therefore important that accounting is transparent and internationally harmonised. We should also keep in mind that accounting rules are not only about preserving financial stability in the short run. Changing the accounting rules could make communication more uncertain and less transparent.

Another tool for telling stories about the future is stress testing. Stress testing can thus be a very valuable and effective tool in restoring confidence. However, this requires that the stress tests are both credible and adequately disclosed. The Fed's stress tests of US banks earlier this year present a good example of how this tool can be used. We – at the Riksbank – have been publishing stress tests of individual banks since 2006. With a track record of reasonable stress tests, the credibility of the methodology and the results has continued to increase during the crisis.

Building confidence in the long-run: liquidity and capital regulation

The financial crisis of the past two years has been very costly. We must ensure that this crisis does not repeat itself. Lawmakers, central banks and financial regulators have a daunting task ahead of them. Regulatory and supervisory reform is needed. I have great hope that we will take this opportunity to create a safer and sounder financial system. In this respect, I would like to bring up two important issues for a safer financial system: liquidity and capital regulation.

Liquidity or, rather, illiquidity has been in the centre of this crisis. Banks will always be exposed to liquidity risk due to the maturity mismatch, as this is a central feature of banking. However, in the run up to the crisis, this maturity mismatch increased too much. Banks relied on the misguided perception that short-term financing would be available from liquid markets. A key lesson from the crisis is that a liquid market can very quickly become illiquid.

The conclusion is that liquidity must be regulated more firmly. Banks need to hold a buffer of liquid assets large enough to allow them to weather a liquidity shock. However, the definition of this liquidity buffer, as well as what type of assets should be viewed as liquid, requires careful thought. We should keep in mind the lesson that market liquidity can vanish quickly and be extremely cautious about what securities we consider to be liquid. Furthermore, the power to dictate the type of assets a bank must hold will have an impact on asset markets. We must ensure that this power is not misused.

From a central banker's perspective, the content of the liquidity buffer has a bearing on the central bank's policy on what assets to accept as collateral. In a crisis, it is the central bank's decision on which securities to accept that defines liquid and illiquid assets – at least in the local currency. Therefore, the interplay of liquidity regulation and the central banks' collateral requirements also warrants considerable reflection.

Finally, liquidity regulation will make maturity transformation more costly. We clearly need more regulation today but, in casting additional regulation, we have to consider the costs. Too strict regulation would stifle competition, make financial services more expensive and, in the long run, hamper economic growth. On the other hand, too loose regulation would inspire speculation with taxpayers' money and also reduce economic growth. Thus, the extent of financial regulation is – at least partly – a question of society's risk tolerance.

Liquidity buffers will create a cushion. However, the root of a liquidity crunch is a lack of confidence. A major aim of regulatory reform should thus be to ensure that trust does not dissipate so rapidly and completely again. In order to do this, we need to increase capital requirements, both in terms of the quality of capital and the amount of capital. After all, capital provides protection against bad outcomes. Increasing the quality and amount of capital will increase the resilience of individual banks. In addition, strengthening the ability of banks to absorb losses mitigates the risk of contagion – therefore more and better capital will also strengthen the resilience of the system.

In my view, the important part of capital is loss-absorbing common equity. In addition, other forms of capital are needed to protect the state. If a bank defaults, capital typically evaporates very quickly. I have seen many examples of banks that have defaulted because they did not meet the capital adequacy rules. In my experience, when bank managers say that they have a problem, they often claim to have – say – 6 per cent regulatory capital, rather than the required 8 per cent. When the authorities eventually and realistically assess the assets, capital is often negative and the state has to bail out the bank. Thus, capital should be of good quality to protect the bank on a going concern basis, but also to protect the state in the event of a default. As some banks may be too big to fail, as regulators we should also discuss the possibilities of creating debt instruments which automatically convert to equity when losses mount above certain trigger points.

Building trust to enhance cross-border crisis management

A financial crisis is costly to resolve. The potential costs are so large that only the nation state, through its power to tax, can shoulder the costs. This makes the state the only ultimate and credible guarantor of financial stability.

Today, we have a mismatch between the geographical reach of the only party that can guarantee financial stability – the state – and the international financial system. The logical solutions to this geographical mismatch are either to shrink the financial system back to within national borders or to create an international institution with a right to tax or a system of burden-sharing, so that confidence in an ultimate guarantor can be established on an international level.

The first solution would be too costly. Basically, it would imply rolling back decades of globalisation and financial integration. Consider, for example, the costs of dismantling a large cross-border bank. It would also mean a serious blow to the European single market. In a way, I find it puzzling that we are discussing the possibility of a single market for all kinds of goods and services except for the commodity most suited for free trade: money. A concrete example of the merits of financial integration is how the arrival of foreign banks resulted in a rapid development of the banking systems in the Eastern and Central European countries. The citizens and corporations of these countries benefitted substantially from early access to advanced financial services.

The second solution – to create an international institution with taxation rights or a system of ex ante burden sharing – is simply not realistic for the foreseeable future.

Consequently, we are stuck with the geographical mismatch and, as a consequence, cross-border banks pose a real challenge to crisis management. To accommodate this mismatch, national authorities must cooperate more effectively. This is the only feasible option. In order to achieve efficient cooperation, it is vital to build trust between authorities, which explains my third ingredient.

In the EU, we have the home country principle as a fix for the geographical mismatch. We have also signed a European Memorandum of Understanding (MoU) aimed at improving cross-border cooperation.

However, the home country principle does not solve the dilemma of international banks and national authorities. Tension arises because the home country is responsible for the supervision of branches but the host country is responsible for the financial stability of the country. This tension also persists if the foreign bank operates through subsidiaries. Many cross-border banks centralise different parts of management. There are good economic reasons for such centralisation. However, the implication is that the home supervisor, as the consolidating supervisor, has the overall picture, while the host country has the responsibility.

In a crisis, decisions must be taken fast and, typically, based on insufficient and uncertain information. Access to information is thus crucial for effective crisis management. In the present crisis, host countries have had difficulties in obtaining timely information from home country authorities. Considering the importance of information, the frustration of host countries is understandable. However, let me emphasise that the problem of insufficient information flows also goes the other way. Home country authorities have also experienced difficulties in getting accurate information from host authorities. A result of the lack of cooperation has been suboptimal solutions, the breaking up of banks and a move towards nationalistic objectives.

Experiences from the crisis prove that it is easy to sign an MoU in good times, but much more difficult to live up to the spirit of that MoU in bad times.

Financial integration will continue. The question, then, is how do we improve cross-border crisis management? Part of the problem today is a lack of mutual trust. In bad times, trust is essential for sharing information. Reaching a joint assessment and making efficient decisions often require frank and open-hearted discussions. Such discussions will not take place if the parties do not trust each other. I believe that we must put effort into building trust among authorities. In this respect, the trust shared among the Governors of the Nordic Central Banks can provide inspiration.

The Governors of the Nordic countries have built trust for a long time. This building of trust dates back to the 19th century. Although it is not very widely known, in 1873, Sweden, Denmark and Norway formed a monetary union based on the gold standard. This union was eventually dissolved in 1924. However, I believe that one legacy of the union has been that the Governors of the Nordic Central Banks – adding Iceland and Finland to the group – have continued to meet regularly since then. This tradition of regular meetings has built trust. It has taken some time, but today the trust is there.

The Nordic example shows that trust between authorities can be achieved, but that trust takes time to build – so patience is warranted. At the same time, we need to start getting this process going immediately. On a European level, I think that the MoU can enhance cross-border cooperation by increasing harmonisation, regulatory convergence and, not least, by building trust. Consequently, we should continue to fully implement the MoU. We are working on this in the Nordic and Baltic countries and are currently establishing a Nordic-Baltic Voluntary Specific Cooperation Agreement. This may serve as an example and, although it may take some time, I am confident that we can increase trust in Europe as well.

Conclusion

In my speech, I have talked about confidence and trust. Confidence is essential for a well-functioning financial system. I have touched upon some reforms and actions that I believe are important to regain and preserve confidence in the banks. I have also talked about how building trust between authorities is essential to enhance cross-border crisis management.

At the very beginning of my speech, I promised to stay within the time-frame. I should, of course, in the spirit of my speech, repay your trust by living up to my promise. But, before I end, I would like to take the chance to stress the need for immediate action. Right now, nobody doubts the need for and the relevance of reforms. But our memories are short. Good times also have a tendency to further shorten our memories of financial crises. So we must take this opportunity to make reforms while the public awareness and the political will are present. It will be a lot of work, but it will pay off.

Thank you!